The Asset Management Review

Seventh Edition

Editor
Paul Dickson

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THE ASSET MANAGEMENT REVIEW

Seventh Edition

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PREFACE

While the global financial crisis of 2007 and 2008 may feel like an increasingly distant memory, its effects continue to be felt across the whole of the financial world. Despite significant improvements in the global economic landscape in the intervening years, global growth has been hampered in recent years by various geopolitical factors, including political uncertainty resulting from the change in administration in the US in 2016 and the rise of populist movements in Europe. As the UK prepares for Brexit, absent any agreement to the contrary currently set to take place in March 2019, political uncertainty remains around the form and extent of any UK–EU deal relating to financial services, and as to whether any transition period (during which UK firms would remain able to access to EU markets on current terms) will be agreed. This has had, and is likely to continue to have, a potentially destabilising effect on the UK asset management sector and its clients. The impact of the UK's decision to leave the EU is thus already being felt, not only in the UK and across the European continent, but also more widely.

Nevertheless, the importance of the asset management industry continues to grow. Nowhere is this truer than in the context of pensions, as the global population becomes larger, older and richer, and government initiatives to encourage independent pension provision continue. Both industry bodies and legislators are also increasingly interested in pursuing environmental, social and governance goals through private sector finance. For example, the European Commission has proposed a package of measures seeking to introduce sustainable finance into current regulations to make it easier for investors to identify and invest in such projects.

The activities of the financial services industry remain squarely in the public and regulatory eye, and the consequences of this focus are manifest in ongoing regulatory attention around the globe. Regulators are continuing to seek to address perceived systemic risks and preserve market stability through regulation. In Europe, further significant changes to the regulatory landscape for investment services were introduced by the revised Markets in Financial Instruments Directive regime (known as MiFID II), which has applied since 3 January 2018. In the UK, the Financial Conduct Authority continues to focus on the asset management industry. In 2017, it published its asset management market study on the performance of the asset management market for retail and institutional investors, and is beginning to implement its findings during the course of 2018. In contrast, the Trump administration in the US has signalled a deregulatory agenda, which includes plans to repeal the Wall Street Reform and Consumer Protection Act of 2010 (also known as the Dodd-Frank Act).

It is not only regulators who continue to place additional demands on the financial services industry in the wake of the financial crisis: the need to rebuild trust has led investors to call for greater transparency around investments and risk management from those managing their funds. Senior managers at investment firms are, through changes to regulatory requirements and expectations as to firm culture, increasing being seen as individually accountable within their spheres of responsibility. Industry bodies have also noted further moves away from active management into passive strategies, illustrating the ongoing pressure on management costs. This may, in itself, be storing up issues for years to come.

The rise of fintech and other technological developments, including cryptocurrencies, data analytics and automated (or 'robo') advice services, is also starting to have an impact on the sector, with asset managers looking to invest in new technologies, seeking strategies to minimise disruption by new entrants, or both. While regulators are open to the development of fintech in the asset management sector, they also want to ensure that consumers do not suffer harm as a consequence of innovations. Regulators across various jurisdictions are working together to develop a global sandbox in which firms can test their new technologies. This continues to be a period of change and uncertainty for the asset management industry, as funds and managers act to comply with regulatory developments and investor requirements, and adapt to the changing geopolitical landscape. Although the challenges of regulatory scrutiny and difficult market conditions remain, a return of risk appetite has also evidenced itself and the global value of assets under management continues to increase year on year. The industry is not in the clear but, prone as it is to innovation and ingenuity, it seems well placed to navigate this challenging and rapidly shifting environment.

The publication of the seventh edition of *The Asset Management Review* is a significant achievement, which would not have been possible without the involvement of the many lawyers and law firms who have contributed their time, knowledge and experience to the book. I would also like to thank the team at Law Business Research for all their efforts in bringing this edition into being.

The world of asset management is increasingly complex, but it is hoped that this edition of *The Asset Management Review* will be a useful and practical companion as we face the challenges and opportunities of the coming year.

Paul Dickson
Slaughter and May
London
August 2018

Chapter 23

SAUDI ARABIA

Nabil A Issa, James R Stull, Macky O'Sullivan and Sayf Shuqair[1]

I OVERVIEW OF RECENT ACTIVITY

The Saudi Arabian economy, while remaining strong and stable relative to other countries in the region, has entered a period of transition. Saudi Arabia remains the largest economy in the Middle East and recorded a gross domestic product of approximately US$640 billion in 2017, a 1 per cent decrease from 2016. While the economy is still driven by abundant oil reserves and related hydrocarbon industries, with oil prices at their lowest in over a decade, the country's leadership has adopted a national transformation plan named 'Vision 2030' to modernise and diversify the economy, and has entrusted a vast amount of assets under the authority of the Public Investment Fund (PIF), which is now the world's largest sovereign wealth fund. Vision 2030 focuses on increasing employment, particularly in the private sector, in retail, education and healthcare. The government has also announced a broad privatisation programme in many key sectors, which is expected to include an initial public offering (IPO) of a 5 per cent stake in Saudi Arabian Oil Company (Saudi Aramco), which analysts believe could be worth upwards of US$2 trillion. The effects of Vision 2030 have been felt, as non-oil sector private sector growth has substantially increased since the start of 2017.

In response to predicted budget deficits, Saudi Arabia has raised billions in sovereign issuances in the past three years (after nearly a decade without any public debt issuances) including:

a in mid-2015, a 15 billion riyal domestic bond sold to local banks, its first sovereign issuance since 2007;

b in October 2016, a US$17.5 billion public bond, the largest ever bond sale by an emerging market nation;

c in April 2017, a US$9 billion *sukuk* (Islamic bond);

d in July 2017, a 17 billion riyal domestic *sukuk*;

e in August 2017, a 13 billion riyal domestic *sukuk*;

f in September 2017, a 7 billion riyal domestic *sukuk*;

g in September 2017, a US$12.5 billion dollar bond; and

h in April 2018, a US$11 billion dollar bond, the largest dollar bond sale by an emerging market country up to June 2018.

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1 Nabil A Issa and James R Stull are partners, Macky O'Sullivan is a senior associate and Sayf Shuqair is an associate at King & Spalding LLP in cooperation with the Law Office of Mohammad AlAmmar.

It is widely speculated that the government will issue an additional sovereign bond and continue to tap into international debt markets to cover the deficit and to avoid further deterioration of its reserves.

The government is also focusing on increasing foreign investment into the country. In a long-awaited and very welcome move, the government opened the Saudi Arabian Stock Exchange (Tadawul) to foreign investment in June 2015, and liberalised the foreign ownership rules in May 2016, August 2016 and January 2018. The Saudi Arabian Capital Market Authority (CMA) has also been encouraging many of the country's blue chip and large family operated companies and financial services companies to list, and created a small cap market, the Parallel Market, in February 2017, which saw 10 listings in its first year. Further, Saudi Arabia has introduced a real estate investment trust (REIT) regime, and in November 2016, Riyad REIT was the first REIT to be listed in Saudi Arabia (and only the second REIT to be listed in the Middle East), and was followed by another 12 REITs up to June 2018. More recently, the CMA has published draft regulations for listed funds that it is believed will spur the development of exchange-traded funds. In general, listings and capital raises in Saudi Arabia have continued to be strong over the past year, while capital markets in other regional and oil-driven economies have dried up, although several of the highly-anticipated Saudi IPOs have been postponed until late 2018 or 2019.

Over the past two years, the CMA has released numerous regulations covering the establishment of new corporate vehicles, the IPO process and foreign investment in Saudi Arabia, and has promised a complete revamp of existing financial services regulations. Three regulations in particular are pivotal for asset managers looking to raise Saudi Arabia-targeted funds: the proposed rules on the offer of securities and continuing obligations, the amended investment fund regulations and the real estate investment traded funds instructions. These new regulations provide opportunities to investment banks, private equity firms and asset managers to expand their product offerings and access additional investor bases.

Saudi Arabia is home to the largest number of investment funds domiciled in the Gulf Cooperation Council (GCC). Funds and asset managers have been gradually diversifying from primarily real estate investments into other parts of the economy, with a particular focus on venture capital and private equity, as these sectors are being supported by the CMA, the Ministry of Labour, the Small and Medium Enterprise Authority (SMEA) and other government institutions. Additionally, managers, investors and many government-owned vehicles are being encouraged to reinvest capital and proceeds into Saudi Arabia rather than deploying funds into foreign investments.

The government has empowered forward-thinking regulators that have implemented relatively clear, stable and predictable funds and capital markets regimes. It is encouraging to many investors and commentators to see the Saudi Arabian markets opening up. As a result, it was recently announced that Saudi Arabia had been reclassified and will join the FTSE emerging market index in March 2019, and that MSCI will add Saudi Arabia to its emerging markets index in June 2019, moves that will potentially foster more growth and lead to a greater influx of capital into the country's markets.

II GENERAL INTRODUCTION TO THE REGULATORY FRAMEWORK

The CMA and the Saudi Arabian Monetary Authority (SAMA) are the governmental bodies that regulate asset management and financing transactions in Saudi Arabia.

The CMA regulates Saudi Arabia's capital markets, including securities, sales of assets, equity securities and debt securities (such as *sukuks*). Its power is granted under the Capital Market Law, which was originally implemented in 2003.

The CMA has issued the implementing regulations governing the management and offerings of securities, including but not limited to the following:

a the Rules on the Offer of Securities and Continuing Obligations, which govern the offering of securities in companies in Saudi Arabia on both a private and public basis;

b the following rules and regulations, which govern the activities, operations and management of companies publicly traded on the Saudi Arabian Stock Exchange and the Parallel Market:
- the Listing Rules;
- the Parallel Market Listing Rules;
- the Merger and Acquisition Regulations;
- the Market Conduct Regulations;
- the Instructions of Book Building Process and Allocated Method in Initial Public Offerings;
- the Regulatory Rules and Procedures relating to Listed Joint Stock Companies; and
- the Corporate Governance Regulations;

c the Rules for Special Purpose Entities, which are intended to promote *sukuks* and the offering of other debt instruments,

d the Rules for Qualified Foreign Financial Institutions Investment in Listed Shares, which govern investment by foreign investors in shares listed on the Saudi Arabian Stock Exchange and the Parallel Market;

e the Investment Funds Regulations, which govern private equity funds, hedge funds, money market funds and private real estate funds, significant amendments to which were implemented in November 2016;

f the Real Estate Investment Traded Funds Instructions, which provide for certain public real estate funds to be listed on the Tadawul as real estate investment traded funds, amendments to which were proposed in February 2018;

g the Real Estate Investment Funds Regulations, which govern publicly placed real estate funds;

h the Credit Rating Agencies Regulations, which regulate and monitor the conduct of rating activities; and

i the Securities Business Regulations, the Authorised Persons Regulations, the Prudential Rules and the Investment Account Instructions, which govern the operations and actions of asset managers.

In late 2017, the CMA issued the Financial Technology Experimental Permit Instructions, which introduce a 'sandbox' accelerator under which certain financial services companies can apply for licences for products and services in new sectors. In February 2018, the CMA issued draft regulations for public consultation governing the establishment and listing of closed-ended funds on the Tadawul.

The SAMA acts as the central bank of Saudi Arabia, and is responsible for issuing currency and regulating the insurance industry. It is also responsible for encouraging the development of the Saudi Arabian banking system in both the public and commercial sectors. Additionally, the SAMA is Saudi Arabia's investment authority, and is responsible for managing the country's assets, both inside and outside of the country, although this role is being largely transferred to the PIF.

With few exceptions, individuals who are not citizens of a GCC country and non-GCC corporate entities (including Saudi entities with direct or indirect non-GCC ownership) must register with the Saudi Arabian General Investment Authority (SAGIA) prior to owning non-listed shares or real property in Saudi Arabia. The SAGIA registration process adds expense and time to any transaction. The primary exemptions to SAGIA registration are ownership in a CMA fund and investment in listed shares (or units in exchange-traded funds or REITs) through the qualified foreign investor (QFI) framework or the CMA-regulated swap regime.

To date, the SAGIA rules have not governed foreign ownership in a CMA fund. Accordingly, there is no requirement that non-GCC investors in a CMA fund obtain SAGIA approval. A foreign investor's ownership of units in a CMA fund is only governed by the rules and regulations of the CMA. Moreover, GCC nationals and companies that are majority-owned by GCC nationals (and partly owned by non-GCC nationals) are permitted to invest directly in listed securities in Saudi Arabia. Additionally, financial institutions that register with the CMA as a QFI are permitted to buy and sell shares of publicly listed companies in Saudi Arabia on their own behalf and on behalf of their clients without SAGIA approval.

III COMMON ASSET MANAGEMENT STRUCTURES

For tax and other regulatory reasons, the majority of structures used in Saudi Arabia are domestically based. The primary structures for asset management in Saudi Arabia are managed accounts and investment funds regulated by the CMA. As opposed to other Saudi Arabian vehicles, a CMA fund is relatively inexpensive to establish and maintain, and allows for significant structuring flexibility. Further, a manager can structure the fund so that investors are truly passive, unlike many other vehicles where investors actually have statutory veto rights and other substantial minority protections.

A CMA fund is a contractual entity formed between the fund manager and its investors upon execution of the terms and conditions of the fund. Under CMA regulations (and from the perspective of other governmental authorities and ministries), a CMA fund is not considered to be a legal entity separate from the fund manager. Accordingly, the Saudi Arabian Ministry of Commerce and Investment (MOCI) will not issue a commercial registration to a CMA fund. Therefore, all actions of a CMA fund, including ownership of real property, assets and shares in Saudi companies, must be performed by a CMA-licensed fund manager or a CMA-licensed custodian on the CMA fund's behalf. The CMA issued a circular in August 2015 requiring that independent CMA-licensed custodians must mandatorily hold the assets of all real estate funds, and in November 2016 adopted amendments to the funds regulations requiring all funds to have independent custodians. These amendments to the funds regulations codify many of the unwritten practices and procedures of the CMA that have been adopted over the past decade.

The Saudi CMA fund is arguably the most efficient vehicle for structuring investments into Saudi Arabia. If properly structured, they create the ability to minimise restrictions from SAGIA and can also provide certain tax efficiencies not available with other structures.

Before the rise in popularity of CMA funds, most collective investment vehicles in Saudi Arabia took the form of limited liability companies. However, they are relatively inflexible vehicles that statutorily provide substantial rights to their shareholders, which makes it hard for managers to enforce any default provisions or even to exit investments or wind down a fund. For example, structuring and enforcing a capital commitment structure in a Saudi limited liability company is very complex. The government enacted new companies regulations in May 2016, which permit single-shareholder companies and give other clarifications to corporate formations and structures. However, it is unlikely that any corporate structures will surpass the popularity of CMA funds, although the SMEA, MOCI and the CMA are jointly collaborating to explore the legal and regulatory framework for companies necessary to nurture start-ups and small businesses.

IV MAIN SOURCES OF INVESTMENT

With over 500 domestic funds currently in operation, Saudi Arabia has the largest number of funds domiciled in the Middle East by a large margin. Historically, investment funds in Saudi Arabia were offered to retail clients and invested in traditional asset classes such as listed equities, money market instruments and corporate and sovereign debt. More recently, the private funds market has thrived. Private funds have tended to invest in real estate, which has been the asset of choice for high-net-worth and institutional Saudi investors and is easier to structure in order to be shariah-compliant than many alternative assets. More recently, there has been a surge in private equity and venture capital funds due to the encouragement of the CMA (and other government authorities) and various incentive programmes. In early 2018 the government introduced a framework for credit funds, and it is expected that several private credit funds will launch later this year in this sector.

Additionally, the Human Resources Development Fund, a governmental body affiliated with the Ministry of Labour supporting employment of Saudi Arabian nationals in the private sector, and Takamol Holding for Business Services, a holding company sponsoring public–private partnerships, launched the Musharakah Programme in 2015. This initiative is focused on addressing the funding gap for SMEs operating in Saudi Arabia by guaranteeing certain financing for funds targeting investments in the SME sector across a range of industries. Accordingly, the past two to three years have seen a surge in newly formed investment funds seeking to participate in the Musharakah Programme and invest in SMEs in Saudi Arabia.

While the vast majority of investors in Saudi Arabian funds are Saudi nationals, Saudi-domiciled institutions and family offices, and government-backed entities and organisations, there is also a significant level of investment from GCC nationals and institutions in such funds. Traditionally, most funds in Saudi Arabia had been publicly offered and had targeted retail investors, but there has been a significant shift toward privately placed funds due to the relative ease of their establishment both in terms of timing and regulatory scrutiny. Since the primary sources of capital for Saudi Arabian funds are family offices and the government, most investors can easily meet the 1 million riyal minimum investment requirement in a private placement.

V KEY TRENDS

i Equity capital markets

The government is encouraging significant investment into the economy from both local and foreign investors. There were many IPOs in 2014, including the IPO of the National Commercial Bank (NCB), which was the largest ever regional IPO, and the second-largest globally in 2014. While Saudi Arabia only witnessed six IPOs in 2015, raising approximately

US$1.4 billion, such trend was reflected in most of the GCC region, which only witnessed two other IPOs (one in the UAE and one in Oman). Saudi Arabia witnessed four IPOs in 2016, including the offering of L'azurde Company for Jewellery, which was backed by regional private equity heavyweights including Investcorp, and the listing of Riyad REIT, the first Saudi Arabian-listed REIT. In 2017, there were 16 IPOs in Saudi Arabia, although all but one (Zahrat Al Waha for Trading Co) were REITs and small-cap listings on the Nomu.[2] It has been speculated that a number of prominent Saudi companies, including ACWA Power, units of Saudi Arabian Airlines, Bateel International, Dar Al-Arkan Properties and potentially Saudi Aramco, are preparing for listing in the near future on the main market of the Tadawul.

In June 2015, foreign investors were permitted to directly own shares listed on the Saudi Arabian Stock Exchange through the QFI framework. The foreign ownership rules were twice liberalised in 2016, with further amendments becoming effective in January 2018. Only foreign institutions that have a minimum of US$500 million in assets under management and five years of experience will be permitted to register with the CMA as a QFI. Once registered, a QFI can purchase or arrange for its clients to purchase shares of companies listed on the Tadawul (except for six companies that have substantial real estate holdings in Mecca and Medina, where ownership of real property is limited to Saudi Arabian nationals). Holdings in a single company by a QFI or its clients will be limited to 10 per cent, and holdings in a single company by QFIs in the aggregate will be limited to 49 per cent.

Prior to June 2015, foreign investors could participate in listed companies through swap arrangements only, which allowed investors to participate in the profits of the companies but did not provide for voting rights. It is expected that, as a result of the new regulations, foreign investment in the Saudi Arabian stock market will grow from US$7 billion to nearly US$35 billion in the future.

In February 2017, the CMA and Tadawul created the Parallel Market to allow for alternative and small-cap listings. This move was widely anticipated and well received, improves SMEs' access to capital and encourages better corporate governance. As of June 2018, nine companies are listed on the Parallel Market.

In October 2016, the CMA's Real Estate Investment Traded Funds Instructions (REIT Regulations) were introduced, which allow managers to list certain public real estate funds on the Tadawul. As of the end of June 2018, the Tadawul is host to 13 listed REITs. It is widely expected that the REIT Regulations will further spur the real estate market in Saudi Arabia.

In February 2018, the CMA issued the Closed Ended Investment Traded Funds Instructions for public consultation. These draft regulations would govern the establishment and listing of certain non-real estate funds on the Tadawul.

ii Debt capital markets

Historically, the majority of debt issues from Saudi Arabia have been in the form of *sukuks*. While it is expected this trend will continue in the long term, the government has recently launched several large conventional bond programs.

Sukuks and bond issuances are regulated by the CMA. It is expected that the CMA will issue regulations in the near future governing the process to list and trade *sukuks* and bonds on the Tadawul.

2 A parallel equity market with lighter listing requirements that serves as an alternative platform for companies to go public. Investment in this market is restricted to qualified investors.

From 2016 through to mid-2018, the government issued US$40 billion in international bonds and *sukuks*, including a US$17.5 billion public bond, along with multiple riyal-denominated *sukuks*. Prior to 2016, most *sukuks* in Saudi Arabia were predominantly domestic, Saudi Arabian-riyal denominated and privately placed.

The current population demographics of Saudi Arabia are significant in supporting strong growth in the domestic consumer market. It is estimated that approximately 80 per cent of Saudi Arabia's population is under the age of 35, providing the potential for a greater demand for property mortgages, automobile loans and general personal borrowing. It is expected that retail lenders will inevitably need to tap the international capital markets to meet the potential increased demand for retail borrowing. The growth of the domestic market should also encourage the expansion of business interests that may require access to debt capital markets to help finance them. A number of Saudi Arabian banks are considering *sukuks* to meet required capital adequacy requirements, and there have been *sukuks* of over 1 billion riyals issued in recent years by NCB, Riyad Bank, Saudi British Bank and AlJazira Bank, which are among the country's largest lenders.

iii Investment funds

The CMA has increasingly scrutinised blind-pool investment funds and real estate development funds. Owing to this heightened scrutiny and the relative ease with which managers can establish private CMA funds, there has been a significant shift toward single asset funds, particularly single asset real estate funds with very limited numbers of investors.

In November 2016, the CMA adopted revised the Investment Funds Regulations, which were intended to provide clarity by codifying unwritten practices of the CMA and encourage more managers to launch funds. The CMA had intended for years to revamp the Funds Regulations to address problems of investor protection that arose during the financial downturn, and to cover the launches of a diverse range of new funds, many of which were not contemplated by the original Funds Regulations that were issued in 2006 (and in fact introduced similar draft regulations in May 2013 that were ultimately not adopted).

Offerings of foreign funds

a Foreign funds may only be offered in Saudi Arabia as a private placement (to investors making an investment of at least 1 million riyals) and must be placed by a CMA-licensed distributor;

b the manager of the foreign fund must be authorised in a jurisdiction that employs regulatory standards and requirements at least equivalent to those of the CMA. It is unclear whether managers established in many offshore jurisdictions would meet these criteria, although the CMA regularly allows for funds domiciled in major offshore jurisdictions to be offered in Saudi Arabia;

c there is a one-year limit on the offering period of foreign funds in Saudi Arabia; and

d the distributor must provide a report to the CMA of all Saudi investors that subscribed for units in the fund.

VI SECTORAL REGULATION

i Insurance

The SAMA regulates the insurance industry in Saudi Arabia. In particular, insurance companies are governed by the Law on Supervision of Co-operative Insurance Companies and its Implementing Regulations, and the Investment Regulations issued by the SAMA.

Every insurance company must adopt an investment policy approved by the SAMA. Any material changes to the investment policy must also be approved by the SAMA.

If the SAMA does not approve an insurance company's investment policy, or an insurance company does not have any investment policy, then the insurance company must adhere to the investment standards set out in Table 1 of the Implementing Regulations (see below), provided that investments outside Saudi Arabia will not exceed 20 per cent of the total investments and are in accordance with Article 59(2) of the Implementing Regulations. Article 59(2) provides that the insurance company must invest 50 per cent of its total invested assets in riyals. The SAMA's written approval is required if the insurance company wishes to reduce this percentage.

The Regulations are silent on what constitutes investments outside of Saudi Arabia.

The Implementing Regulations		
Investment type	**% for general insurance**	**% for protection and savings insurance**
Saudi authorised banks	20 maximum	10 maximum
Saudi government bonds	20 maximum	10 maximum
Saudi riyal-denominated investment funds	10 maximum	15 maximum
Foreign currency-denominated investment funds	10 maximum	10 maximum
Foreign government bonds	5 maximum	5 maximum
Bonds issued by domestic companies	5 maximum	5 maximum
Bonds issued by foreign companies	5 maximum	5 maximum
Equities	15 maximum	15 maximum
Real estate in Saudi Arabia	zero maximum	5 maximum
Loans secured by real estate mortgages	zero	5 maximum
Loans secured by policies issued by the insurer	zero	5 maximum
Other investments	15 maximum	15 maximum

Insurance companies must take into account the investment concentration risks. Concentration in an investment instrument must not exceed 50 per cent in any one of the investment instruments mentioned in the table above.

Insurance companies are prohibited from investing in derivatives, option contracts, hedge funds, deposits with foreign banks, private equity investments and any off-balance sheet instrument, and these should also not form part of the insurance company's asset allocation unless specifically approved by the SAMA, and must be based on efficient portfolio management justification. An insurance company can, with the approval of the SAMA, invest in derivatives subject to the following conditions:

a such derivatives must be listed on a stock exchange, capable of being readily closed out and based on underlying admissible assets, and must have a prescribed pricing basis;

b the insurance company must set aside assets that can be used to settle any obligations under these derivatives, and set out adequate provisions for any adverse changes to the derivatives and their coverage; and

c the counterparty must be reputable and in an acceptable financial condition.

Investment in *sukuks* is allowed provided they are equivalent to bonds and the percentage allocation in them does not conflict with those outlined in Table 1. The maximum limit of allocating *sukuks* that are issued by local companies in which the government has a significant ownership is 20 per cent, and the solvency margin is equivalent to the government's participation in the capital.

ii Pensions

There are two large governmental institutions in Saudi Arabia focused on pensions and payments of employee benefits: the Public Pension Agency (PPA) and the General Organisation for Social Insurance (GOSI). Additionally, Saudi Aramco Investment Management Company (SAIMCO), which invests the capital for the Saudi Aramco pension and retirement plans, is a big player. Otherwise, private pension plans are not particularly active players in asset management in Saudi Arabia.

PPA

Government employees in Saudi Arabia are entitled to pensions of up to 80 per cent of their final salary. The PPA, which is a division of the Saudi Arabian Ministry of Finance, manages all retirement programmes for civil and military pensioners.

The PPA primarily invests in shares of Saudi Arabian companies listed on the Saudi Arabian Stock Exchange, and it is believed that its local stock market holdings are worth more than 40 billion riyals. However, the PPA also has substantial investments in real estate and fixed income products.

GOSI

All employers in Saudi Arabia are obligated to register with the GOSI, and to enrol all Saudi and non-Saudi employees in the GOSI. The payment obligations to the GOSI are as follows:

a Saudi employees are required to be registered under the Annuities Branch of the GOSI subject to the payment of 18 per cent of the employee's wage. The employer shall pay 9 per cent of the subscription amount, and the remaining 9 per cent must be deducted from the employee's salary on a monthly basis; and

b Saudi and non-Saudi employees are required to be registered under the Occupational Hazards Branch of the GOSI. The employer shall pay the subscription amount of 2 per cent of the employee's wage for Saudi and non-Saudi employees.

Over 6 million individuals and corporate bodies are covered by this regime.

GOSI investments are distributed among a number of major investment fields such as cash investments, bonds, loans, shares and real estate investments, but the GOSI is primarily focused on international private equity investments. The GOSI follows a long-term investment management strategy that aims to avoid risks, seeks large revenues that enable it to meet its liabilities towards its contributors and beneficiaries, and concentrates on profitable local investments. Although the direct objective of GOSI investments is to maintain fund sustainability to cover contributors' insurance benefits, they also indirectly support development projects in Saudi Arabia. These investments are usually directed to developmental projects that play an important role in containing labour force and developing human and material resources.

It is estimated that the GOSI has US$116 billion in assets under management, invested primarily in Saudi Arabian listed equities with additional investments in other securities and financial instruments and real estate.

Saudi Aramco

Another active player is Saudi Aramco, the government-owned oil and gas company. Saudi Aramco is quite different from the government entities described above, as it is primarily an industrial operating company, and less frequently associated with the financial services and asset management industries. However, with annual revenues of over US$300 billion, Saudi Aramco is an active investor in technology, energy and venture capital investments both in Saudi Arabia and worldwide. Through its investment management division, SAIMCO, Saudi Aramco invests a substantial portion of its revenues for the benefit of its retirement and pension plans. Saudi Aramco's energy investments division, Saudi Aramco Energy Ventures, is also an active investor both in Saudi Arabia and abroad.

iii Real property

The Real Estate Finance Regulations were passed in July 2012 and provide a provisional framework for secured and structured finance transactions pertaining to real estate assets. This is a positive development for the potential growth of an asset-backed securitisation market in Saudi Arabia.

Public real estate funds are governed by the Real Estate Investment Funds Regulations implemented by the CMA. Public real estate funds that also comply with the REIT Regulations can be listed on the Saudi Arabian Stock Exchange. All privately placed real estate funds are governed by the private placement rules in the Investment Funds Regulations, which are significantly more comprehensive and provide managers with much greater flexibility. The vast majority of private funds in Saudi Arabia are real estate-focused.

In July 2012, Saudi Arabia released the long-anticipated Real Estate Registered Mortgage Regulations (Mortgage Regulations). The Mortgage Regulations provide the foundation for the creation of all mortgages in Saudi Arabia. The legislation represents a significant milestone in the registration, prioritisation and enforcement of security rights within Saudi Arabia. Many asset managers believe this will increase liquidity for potential home buyers in Saudi Arabia, and as a result are keen to acquire and develop properties. Most banking transactions have not yet complied with the Mortgage Regulations; however, the SAMA has recently issued circulars requiring banks to start registering mortgages under the Mortgage Regulations, and has issued various incentives for mortgage holders.

iv Hedge funds

Hedge funds are regulated by the Investment Funds Regulations, which provide specific requirements regarding the diversification parameters and amount of leverage a fund can incur. Further, the regulations require that all open-ended funds allow for sales and redemptions at least twice a week. These subscription and redemption requirements apply unless formally waived by the CMA. However, the CMA has taken the position that such requirements do not apply to private placed funds.

v Private equity

Saudi Arabia witnessed a considerable decrease in private equity deal value and volume in 2016 and 2017 (compared to prior years) driven by consistently low oil prices (which began to rebound later during this period), uncertainty regarding the impact of regulatory, legal and fiscal reform (which included a major anticorruption campaign in November 2017) and the occurrence of several geopolitical events in the region. A number of investors have commented that this makes forecasting potential investees' future results more difficult, resulting in a lower level of deals in Saudi Arabia.

As previously mentioned, the new draft Investment Funds Regulations became effective in November 2016. The Regulations allow Saudi-domiciled funds to implement many of the terms utilised by managers based in more developed markets that are prevalent in private equity funds in traditional funds jurisdictions.

We continue to see an increase in the use of single asset funds for private equity deals. Privately placed CMA funds offer a means to pool Saudi, GCC and foreign investors in a vehicle to acquire an asset, while avoiding the challenges involved in partly foreign-owned limited liability companies making private equity investments in Saudi Arabia.

The SMEA is spearheading a review of the private and equity and venture capital environment in Saudi Arabia in an effort to make it easier for entrepreneurs to establish small businesses and for investors to comfortably provide capital to Saudi-domiciled companies.

vi Other sectors

Most investment in Saudi Arabian funds and other vehicles comes from two investor classes: family offices and investment companies, and government entities.

Family groups such as SEDCO, Olayan, Al Fozan, Muhaideb, Bin Saedan, Al Rajhi and MASIC are major players in the asset management field in Saudi Arabia. Many of these groups are now CMA-licensed themselves or substantial shareholders in CMA-licensed entities, and are moving from their traditional roles of investing family money to a new role of raising and managing third-party funds.

While Saudi Arabian government investment vehicles historically have not been as prominent as some of the sovereign wealth funds elsewhere in the GCC (such as the Abu Dhabi Investment Authority, the Qatar Investment Authority and the Kuwait Investment Authority), the government is a major player in the asset management and investment arenas, particularly with the astronomical growth of the PIF over the past three years. The SAMA, the GOSI, the PIF and other government-owned organisations are estimated to have over US$1 trillion under management (not including Saudi Aramco, which is owned by the PIF and which is estimated to have a value of between US$2 trillion and US$10 trillion). The majority of that sum is deployed in non-Saudi investments, although there has been a strong push for these organisations to increase the amounts of their investments in Saudi Arabia. The PIF in particular is expected to dramatically grow in size in the foreseeable future, as the government intends to convert it into Saudi Arabia's primary sovereign wealth fund and has moved its stake in Saudi Aramco to the fund. Additionally, the PIF made waves in June 2016 when it closed on a US$3.5 billion investment in Uber, in October 2016 when it announced it would be investing up to US$45 billion in SoftBank Vision Fund and, again in October 2017, when it committed US$20 billion to a Blackstone infrastructure fund.

The growth of the PIF comes on the heels of the government recently establishing two sovereign wealth funds: Sanabil Al-Saudia in 2008 and Hassana Investment Company in 2009. Sanabil and Hassana were established to manage the assets and investments of the PIF and the GOSI, respectively. The intention of these organisations is to diversify the existing investments of the PIF and the GOSI within the various industries of Saudi Arabia, and also to provide training and expertise to Saudi nationals. Additionally, it has been announced that Saudi Arabia will establish another sovereign wealth fund, and it is expected that the National Reserve Fund will be officially launched in the near future.

The Islamic Development Bank (IDB) is a multilateral development financing institution owned and funded by 56 primarily Islamic countries spread across the globe and headquartered in Jeddah, Saudi Arabia. IDB has long invested in infrastructure projects and educational programmes, but is also becoming a more active investor in both regional and international shariah-compliant private equity funds, real estate funds and other alternative investments. Further, IDB, as a highly rated supranational body, has become an important issuer of *sukuks*, in addition to being an increasingly important and active investor in funds.

While endowments of universities and colleges are not major institutional investors generally in Saudi Arabia, King Abdullah University for Sciences and Technology (KAUST) is a powerful exception. KAUST, which opened in 2009, is an international, graduate-level research university in Saudi Arabia dedicated to inspiring a new age of scientific achievement in Saudi Arabia. With an endowment of approximately US$20 billion, KAUST is a respected, and frequently approached, institutional investor. Its focus is on the advancement of science and technology to improve the lives of people in Saudi Arabia and the world, but it invests across asset classes both inside and outside Saudi Arabia.

VII TAX LAW

Taxation in Saudi Arabia is administered by the Saudi Arabian General Authority for Zakat and Taxation (GAZT). The main taxes levied on businesses in Saudi Arabia are income tax on business profits and *zakat* (i.e., mandatory Islamic charitable giving).

i Zakat and income tax

The tax exposure of wholly Saudi-owned and GCC-owned entities formed in Saudi Arabia is limited to *zakat* and, for entities formed in other GCC jurisdictions, a withholding tax on dividends and capital gains. A Saudi Arabian corporate vehicle will only be subject to *zakat* at 2.5 per cent on the higher of its net worth or its profits so long as it is wholly owned by Saudi or GCC shareholders, or both.

To the extent that a portion of a Saudi-domiciled corporate entity is owned by non-GCC foreigners, a corresponding portion of the entity's profits will be subject to tax at a rate of 20 per cent on such profits. The portion of the entity's profits corresponding to the ownership by Saudi and GCC shareholders will continue to be subject to *zakat* at a rate of 2.5 per cent.

The Saudi Arabian tax and *zakat* regulations provide for the look through of ownership shareholdings in a Saudi Arabian company from a GCC state to determine whether such shareholding should be subject to income tax. This means that if any of the corporate shareholders in a Saudi-domiciled corporate structure that targets Saudi investments has any non-GCC foreign shareholders, the Saudi-domiciled company will be liable to pay income tax to the extent that its ultimate owners are non-GCC foreigners.

Additionally, in June 2016, the Cabinet approved the introduction of a tax on undeveloped real estate. While the implementing regulations for the tax are still being introduced, the government intends to impose a 2.5 per cent annual tax on the value of undeveloped urban land.

ii Withholding tax

A withholding tax is payable on payments for income derived from Saudi Arabia made to non-Saudi nationals and companies. Withholding tax will not apply to non-Saudis who are resident in Saudi Arabia or have a permanent establishment in Saudi Arabia.

If a Saudi company or individual makes a payment that is from a source in Saudi Arabia to a non-Saudi, then such payment is subject to withholding tax at various rates depending on the nature of the payment. The withholding tax will not apply to payments made on contracts for goods, but will apply to payments made for services and on interest payments under loan agreements.

A dividend paid by a Saudi Arabian company to a non-Saudi resident shareholder results in withholding tax at a rate of 5 per cent. This tax will apply to dividends attributable to non-Saudi GCC shareholders and non-GCC foreign shareholders.

Capital gains on the sale of shares in an unlisted company in Saudi Arabia by a non-resident shareholder results in withholding tax at a rate of 20 per cent on the amount of the gain. This tax will apply to non-Saudi GCC shareholders and non-GCC foreign shareholders.

iii Value added tax

In January 2018, value added tax (VAT) of 5 per cent became effective in Saudi Arabia on most transactions. This is currently only assessed on transactions between Saudi parties. As such, a foreign manager or adviser would not be assessed for VAT on fees charged to Saudi clients. However, fees payable to a Saudi manager or adviser by a Saudi client would be subject to VAT.

iv Effect of Saudi tax issues on structuring

To avail itself of the least tax exposure, any corporate vehicle organised in, or conducting business within, Saudi Arabia should be structured so that it is Saudi-domiciled and wholly owned by Saudi or GCC nationals, or both (i.e., foreign investment should not be sought at the Saudi or GCC level) to avoid exposure to income tax at a rate of 20 per cent (on the portion of profits relating to its foreign shareholders); and the exit of the shares in the target company in Saudi Arabia from the investment should be done by a holding entity in Saudi Arabia.

A 100 per cent Saudi or other GCC-owned entity incorporated outside the GCC (e.g., in the Cayman Islands) will be treated as a foreign entity for the purposes of the regulations in Saudi Arabia.

v Exceptions

Saudi funds are extremely tax-efficient vehicles. To date, the GAZT has not assessed any taxes on Saudi funds, their investments or unitholders in a Saudi fund; however, it has reserved the right to tax funds in the future and on a retroactive basis, and in fact the Shura Council, an influential advisory body to the government, has recommended that closed-ended investment funds be subject to tax. Therefore, it is recommended that parties closely consult with tax advisers in Saudi Arabia and take into consideration the fact that a tax may be applied retroactively.

VIII OUTLOOK

Saudi Arabia has the largest economy in the Middle East. Following the significant slump in the price of oil, the government is maintaining aggressive plans to grow, modernise and diversify its economy. Accordingly, this is an exciting time for the asset management industry, particularly with the opening of the Tadawul to foreign investors and the introduction of new regulations intended to spur foreign investment and new products in the country. Additionally, the funds industry in Saudi Arabia has been a success story compared with the rest of the region, and locally domiciled funds have flourished. The CMA and other regulators have encouraged this growth and stability, and have been revolutionising the structuring of private equity and real estate deals in Saudi Arabia. Finally, the extensive activity of the PIF and other government bodies has created many opportunities for those operating in the asset management industry and other investment sectors. As such, it is expected that Saudi Arabian markets will continue to expand in the coming year.

Appendix 1

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Nabil A Issa is a partner at King & Spalding LLP. He splits his time between the Dubai and Riyadh offices. He is one of the market leaders for structuring and establishing investment funds and other vehicles in the GCC, with a particular focus on Saudi Arabia. His practice focuses on funds, corporate and finance matters, particularly on a shariah-compliant basis. He is regularly ranked as one of the leading lawyers in Saudi Arabia by *Chambers Global*, *Islamic Finance News* and *The Guide to the World's Leading Islamic Finance Lawyers*.

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